Mergers in the Telecommunications Industry

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Thank you for the opportunity to appear before you this morning. As a director of the Schwab Washington Research Group, I examine regulatory and legal issues affecting the investment decisions of institutional investors. Schwab does not make specific stock recommendations and does not engage in investment banking. Our goal is to provide objective advice to our institutional client base. Obviously, the investment community has a major interest in telecom mergers. They speculate about possible combinations, they react to news of proposed deals, and they monitor the progress of these mergers as they work their way through the regulatory review process.

As a consequence of technological change, deregulation and the emphasis on global market opportunities, the telecommunications industry has experienced significant consolidation, particularly among the top tier players. Seven Regional Bell Operating Companies (RBOCs) have merged into four; significant mergers have also occurred in the long distance and cable industries. Ten years ago, the top seven cable operators served about 25 million subscribers. Today, the top seven multiple system operators (MSOs), including proposed deals, serve about 60 million subscribers, almost 90 percent of all cable subscribers.

We're seeing consolidation in the wireless business as well. Wireless providers have combined to broaden their reach to more subscribers. Consolidation is occurring among wireless providers using the GSM (Global System for Mobile Communications) standard, a development that may encourage integration with a major landline carrier or a possible arrangement with foreign carriers that rely on the GSM standard.

Why is consolidation happening? Telecommunications is a capital-intensive business with very high fixed costs and increasing demands for the integration of new technology. Greater scale allows these costs to be spread over a wide customer base, ultimately reducing the cost of serving each individual customer. With deregulation, providers envision a world in which they offer a package of telecom services over digital, packet-switched networks on a global basis at affordable rates. Carriers are acquiring assets to become end-to-end providers of telecom services, maintaining sufficient control over their networks to enable customer access, ensure timing of service deployments and guarantee network reliability. Greater scale and a more expansive customer reach, in turn, enhance a provider's attractiveness as a potential global partner.

In this environment, we should not be surprised to see rapid consolidation. Looking years ahead, business leaders in the telecom world envision a multi-service broadband environment on a global scale. They're making big bets to prepare themselves for that future. We may reach a point where consolidation will yield a small number of very large industry players.

At the same time, each industry player must pursue its vision in a regulatory climate governed by the Telecommunications Act of 1996. The Act was designed primarily to open the local market to competition. Rather than depend on benevolent compliance with rigid statutory demands, the Act created an incentive structure that would encourage local incumbents to meet the market-opening requirements of the Act. The incentive for local incumbents was entry into the in-region long distance market. The Act offered a legislative judgment that ending the monopoly over local phone service was in the public interest. The Act also recognized that competition was superior to government regulation, including provisions that allow regulatory forbearance where telecom regulation is unnecessary to protect the public interest.

At times, the visions of telecom carriers may collide with the vision of the Telecom Act. This is inevitable if the Telecom Act failed to contemplate the extent of technological change and convergence. Businesses are merging to broaden their reach into new services and to obtain scale in a market where service providers can bring all services over the same pipes. The growth market now and in the future is the data services market. A broader reach means efficiencies that can lower costs for consumers. Yet the FCC must administer an Act that has imposed on the FCC an obligation to ensure competition emerges, particularly in the local service market. Anything that threatens that vision raises public interest concerns as they are expressed through the Telecom Act.

Accordingly, the FCC, in considering license transfers essential to the completion of mergers, examines the impact of a merger on its statutory obligations and its rules. The public interest embodied in the Telecom Act will not necessarily coincide with the business objectives of merging parties. But both sets of objectives are legitimate and, in most cases, the FCC approves license transfers with little fanfare. Where large mergers have sparked public interest concern, the FCC has worked out conditions with the merging entities to allow such deals to move ahead.

Nevertheless, the FCC has been criticized for taking too long to approve license transfers. It has also received criticism for imposing merger conditions that address policy concerns that may not bear directly on the principal competitive concerns that generated initial public interest scrutiny of a particular merger proposal. The FCC has announced efforts to deal with these concerns, and progress in this regard would be useful to the financial community. Investors need as much regulatory certainty as possible as they focus on the strategic and financial merits of particular transactions. Uncertainty about regulatory timing or the potential regulatory consequences attached to a specific deal can muddy the environment in which fundamental analysis takes place. Investors would welcome improvements in the predictability of the overall merger review process.

Thank you again for the opportunity to appear before the Committee.

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